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C O N F I D E N T I A L BAKU 000023

SIPDIS

EEB FOR TIM GILMAN
EUR/ERA FOR BENJAMIN ROCKWELL
TREASURY FOR JEFF BAKER

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TAGS: [ECON](#) [EFIN](#) [ETRD](#) [EXIM](#) [EINV](#) [AJ](#)
SUBJECT: IFIS WEIGH IN ON EFFECT OF GLOBAL FINANCIAL CRISIS
IN AZERBAIJAN

REF: 08 BAKU 863

Classified By: Political-Economic Counselor Rob Garverick, Reasons 1.4
(b and d).

¶1. (C) Summary: In early December, EconOffs met separately with representatives of the EBRD, IMF, and World Bank in Azerbaijan who unanimously expressed confidence that the Azerbaijani economy and banking sector would be able to absorb the twin shocks of the global credit crisis and the sharp decline in energy export prices with only a modest decline in economic growth over the near term. They did express some concern that the housing and construction sectors were vulnerable to a sharper downturn in the longer run if commercial banks continue to curtail real estate and consumer lending. The financial experts noted that Azerbaijan may find budget implementation tricky this year. Inflationary pressures, which have been strong, may ease because of lower commodity prices. The manat (currency) is likely to be stable, as Azerbaijan runs a current account surplus, has large reserves, and few debt instruments exist for potential speculators. Weaker currencies in neighboring states, particularly Russia and Ukraine, could lead to cheaper imports, putting a hurt on Azerbaijan's non-energy sector. End Summary.

International Monetary Fund (IMF)

¶2. (C) On December 2 EconOffs met with IMF Resident Representative Koba Gvenetadze to discuss the economic outlook for Azerbaijan and other key issues. The IMF expects some slowdown in Azerbaijan's economic growth due to the global credit crunch, as domestic commercial banks have cut back on providing consumer credit. Gvenetadze indicated that the real estate market is particularly vulnerable, and has heard anecdotal reports that inventories of unsold apartments in Baku are on the rise. He noted that because of the global credit crisis domestic banks will not be able to roll over outstanding external lines of credit, but that the total external credit currently held by Azerbaijani banks is small at 2.6 billion USD, of which 1 billion USD is due next year. Meanwhile, Azerbaijan claims its reserves exceed 18 billion USD, thanks to windfall oil profits.

¶3. (C) Gvenetadze said that the National Bank of Azerbaijan's December 1 decision to reduce reserve

requirements was the third policy adjustment this year. He believes the NBA has perhaps acted too quickly and might have been better off waiting to see the next set of inflation figures before injecting additional liquidity into the banking system. He suggested that the reason for these proactive efforts might be due to pressure from commercial banks or because, as the central bank, the NBA has access to confidential banking information which suggests the sector is under more stress than the GOAJ has been willing to admit.

¶4. (C) Regarding the budget, Gvenetadz opined that the GOAJ has not yet decided exactly how it will implement the budget in 2009, particularly in terms of transfers to the budget from the State Oil Fund (SOFAZ) even though a notional amount had been announced. (NOTE: The official budget was published on December 11, details reported septel. End Note.) He indicated that GOAJ officials are aware that budget flexibility in the year ahead will be necessary to handle the uncertainties related to fluctuating oil prices and the global financial crisis. He said that non-oil economic growth will also be slowed by the reduction in government spending increases in 2009. The key question will be what programs GOAJ will choose to cut.

¶5. (C) Gvenetadze anticipates that the fall in global commodity prices will allow 12-month inflation to register near 17 percent, down from an earlier estimated 21-22 percent, for 2008. However, he acknowledged that inefficiencies in the customs office are also likely to produce some stickiness in prices and will impede the transmission of lower import prices to domestic consumers.

¶6. (C) Gvenetadze stated that the IMF considers official GOAJ statistics on key macroeconomic variables such as GDP and inflation to be fairly accurate and worth using as indicators, although he commented that the data is by no means perfect. He conceded that some data, such as that on labor and balance of payments are less reliable. Specifically, unemployment information is not particularly dependable because of the challenges of conducting surveys on a regular basis. Balance of payments data is thought to be less reliable in part because remittances are difficult to estimate.

European Bank for Reconstruction and Development (EBRD)

¶7. (C) EconOffs met with EBRD Senior Banker and Head of Office Francis Delaey on December 4 to discuss banking and business conditions in Azerbaijan. Delaey noted that the EBRD works directly with 9 banks in Azerbaijan, some of which are more vulnerable than others. He confirmed that Unibank took out a 50 million ANZ loan from the NBA, and suggested that it may still need to borrow additional funds in 2009 to address liquidity issues. He noted that other banks are in a better position but may need some help meeting liquidity needs. Delaey does not consider the problems threatening Azerbaijan's economy and banking sector to be a direct result of the global financial crisis, but rather a peripheral development. He expects the biggest threat to come from a sharp downturn in the real estate market, which would have repercussions on the banking sector.

¶8. (C) He remarked that most banks have become much more conservative, especially in consumer lending and mentioned rumors that obtaining consumer credit is increasingly difficult. He suggested that, if true, this could negatively impact companies which rely on consumer credit for "big ticket" sales, such as car dealerships. He also noted that many bank loans are secured by real estate and suggested that this could trigger a fall in real estate prices, as banks cut back on lending "perhaps exacerbated by the global credit crunch," which could precipitate a decline in housing prices. Delaey said he expects the property market in Baku to undergo a substantial correction but suggested that even if that were to happen, the GOAJ could be in a position to buy

up unsold apartment blocks from private developers and then offer this housing to civil servants and others. While not recommending complacency regarding the potential for a downturn in Azerbaijan's economy, Delaey implied that the situation would not be as challenging as that in Kazakhstan, Ukraine, or Russia. He flagged the potential for economic issues in neighboring economies to affect Azerbaijan's competitiveness and suggested that local non-oil sectors were already struggling because, with the ruble's depreciation, imports from Russia are now more competitive. He offered milk as an example of a product where imports were more competitively priced than local products.

¶9. (C) According to Delaey, the EBRD plans to allocate 50 million USD to the banking sector in 2009 and is interested in assisting Azerbaijan's infrastructure development, but there are no such projects in the pipeline. Part of the difficulty in winning project bids is that EBRD financing tends to be more expensive than commercial bank loans and the EBRD has conditionality requirements for procurement, etc. In light of the global financial crisis, however, he expects that investors will find it more difficult to raise money from commercial sources and this may be an impetus for Azerbaijan to increase its engagement with IFIs like the EBRD. Nonetheless, Delaey said he doesn't think the GOAJ has yet fully realized how much the lending environment has changed because of the global financial crisis.

World Bank

¶10. (C) On December 15 EconOffs met with World Bank Country Manager Gregory Jedrzejczak and Senior Operations Officer Saida Bagirli to discuss recent macroeconomic developments and economic reforms. World Bank officials say that they

have been working with MoED, MinFin and NBA on modeling macroeconomic indicators, highlighting the difficulty the uncertainty of future oil prices adds to that task. They believe GOAJ officials understand the 70 USD per barrel price assumption in the 2009 budget is likely overly optimistic. They commented that the oil price assumption really only influences how much of the budget is raised through taxes and that any decline in the flow of tax revenues into the budget will be offset by transfers from the oil fund, and that the GOAJ budget staff is really only concerned with planning expenditures. They noted that the war in Georgia, the drop in oil prices, and global credit conditions have led to some confusion within the GOAJ about prudent macroeconomic policy. Some officials have questioned them why GOAJ should curb fiscal spending when places like the US and Europe are embarking on massive fiscal stimulus packages. World Bank officials stressed that as long as there is money in the oil fund, GOAJ has the luxury of keeping public spending high.

¶11. (C) The World Bank expects inflationary pressures in Azerbaijan to decrease as global prices for oil, steel, concrete and other commodities decline. Jedrzejczak suggested that there is likely to be a struggle within GOAJ as some officials and influential business-people may be interested in keeping some of these prices artificially high. He noted that there is an unofficial freeze on new construction in Baku although GOAJ officials are not likely to acknowledge this. He said there have been anecdotal reports that some construction firms are having difficulties raising financing for projects, noting a collapse in the real estate sector would probably prompt GOAJ to buy up new, unsold apartments and essentially bailout housing developers.

¶12. (C) According to the World Bank, Azerbaijani banks are on relatively sound footing, having largely relied on local sources of capital, and therefore are not significantly vulnerable to external exposure. It does not foresee a steep drop in the value of the manat as there are no local public debt instruments which investors could use for foreign exchange speculation. The financial sector is not expected to experience problems in the near term. However, there are risks in the real sector from a number of factors.

These include oil prices, lower foreign remittances, and an increasingly uncompetitive environment where technology is weak and there are many informal, artificial monopolies. World Bank experts noted that a ruble devaluation could facilitate the importation of cheap Russian products which could prompt GOAJ to implement additional non-tariff measures at the borders. All of these factors, they noted, could lead to notable increases in unemployment.

Comment

¶13. (C) The Azerbaijani economy is well-positioned to avoid a sharp contraction but growth is likely to experience some slowdown particularly in the non-oil sector. However, there are considerable risks to this assessment as oil prices continue to be a significant point of uncertainty. The near-term risks faced by the financial sector are limited but the real estate and construction sectors are in a more vulnerable position. Although public expenditures in the 2009 budget show a more modest 15 percent increase over last year, the reserves held by the State Oil Fund provide a funding source that GOAJ will probably increasingly rely upon to compensate for the decline in oil export revenues. SOFAZ's strong financial position will insulate the GOAJ from having to cut back drastically on planned expenditures in the near-term but ongoing transfers from SOFAZ to the general budget will probably continue to undermine the Fund's function as a reserve for future generations

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